

Annual Review of Monetary Policy for 2010-11 - Expectations

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Highlights

- RBI expected to hike LAF Repo & LAF Reverse Repo rate by 25bps each
- RBI expected to hike the Cash Reserve Ratio by 25bps
- No moves expected on SLR and Bank Rate
- Hike in interest rates would be done primarily to control build-up in inflation expectations
- Economic data shows strength but, without signs of overheating
- Progress in IIP & GDP is in line with past trend
- Higher aggression on rates at this juncture may hurt growth
- Benign base effect to aid softening of annual inflation rate in 2010-11
- Huge borrowing programme to weigh on decision to hike rate at this juncture
- A move on CRR would be step further in unwinding of liquidity infusing measures taken at the time of financial crisis
- CRR hike undertaken as a sterilization measure would act as a tax on the banking system
- Usage of T-Bills under MSS is a more market friendly method for sterilization of liquidity

At its upcoming Annual Review of Monetary Policy for 2010-11, we expect the RBI to hike the Cash Reserve Ratio by 25bps. We also expect the RBI to hike the LAF Repo rate and LAF Reverse Repo rate by 25bps each to 5.25% and 3.75% respectively. We do not expect any moves on SLR and Bank Rate.

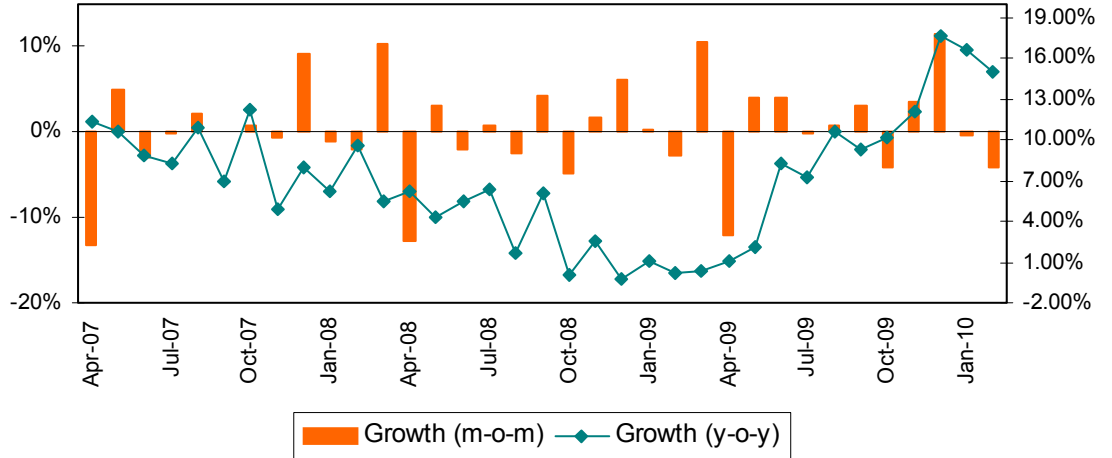
In our preview report we would be discussing the factors affecting moves on CRR and interest rates and also deliberations as to why the RBI may choose not to be more aggressive at this juncture.

Economic Growth - Proceeding as Expected and on a Strong Footing

At the Third Quarter Review, RBI decided to maintain a status quo on interest rates as the economic recovery had just begun and was yet to be established on strong foothold. However, within two months of the quarterly review, RBI announced a mid-policy rate hike of 25bps on both LAF Repo and LAF Reverse Repo. Main reasons sighted for this move were strengthened reading on IIP and buoyant estimates on GDP growth, along with accelerating annual inflation rate.

The data releases on IIP since the second quarter do point to a strong recovery. The growth in index number has been stronger than previous year but, quite in line with the trend seen over the past years. Even the data on GDP has been depicting growth that is in line with the trend

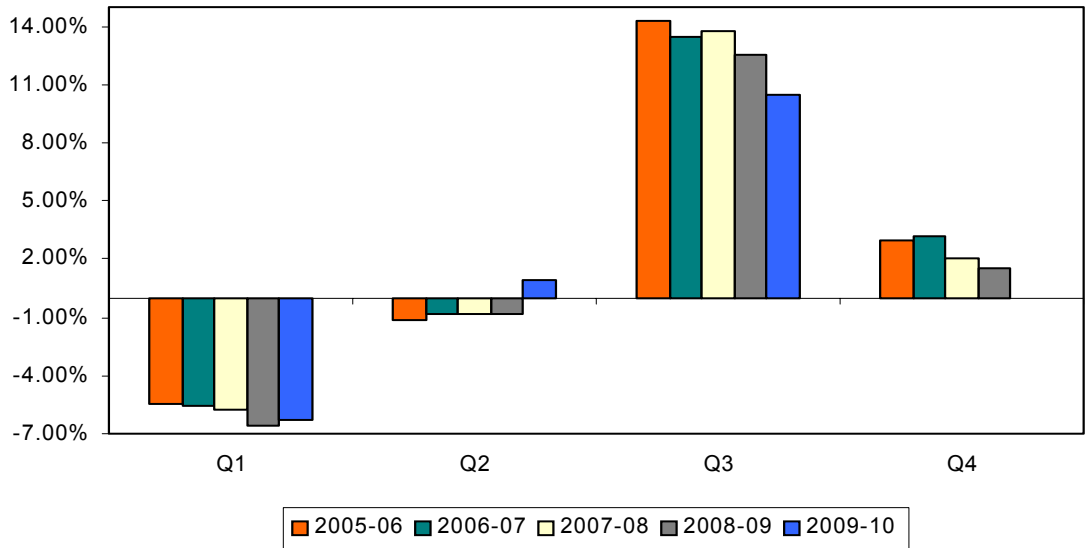
Figure 1: IIP Growth (m-o-m & y-o-y)



Source: IDBI Gilts Limited, CSO

The IIP growth on a m-o-m basis shows movement in line with trend but; the annual growth rates seen in double digits are purely a statistical phenomenon

Figure 2: GDP Growth (q-o-q)



Source: IDBI Gilts Limited, CSO

The analysis of q-o-q GDP growth also presents a picture of economy that is moving largely in line with the trend. The fiscal 2008-09 was an exceptional year, wherein the growth rate was quite below the trend seen over past few years. An analysis of 2009-10 points to a considerable recovery in numbers. The first quarter growth was in line with trend but, the second quarter saw a more buoyant growth number tracking surprise upside on industry and services. Therefore, a below trend q-o-q growth observed in third quarter was primarily a statistical phenomenon and also due to a softer growth in agriculture.

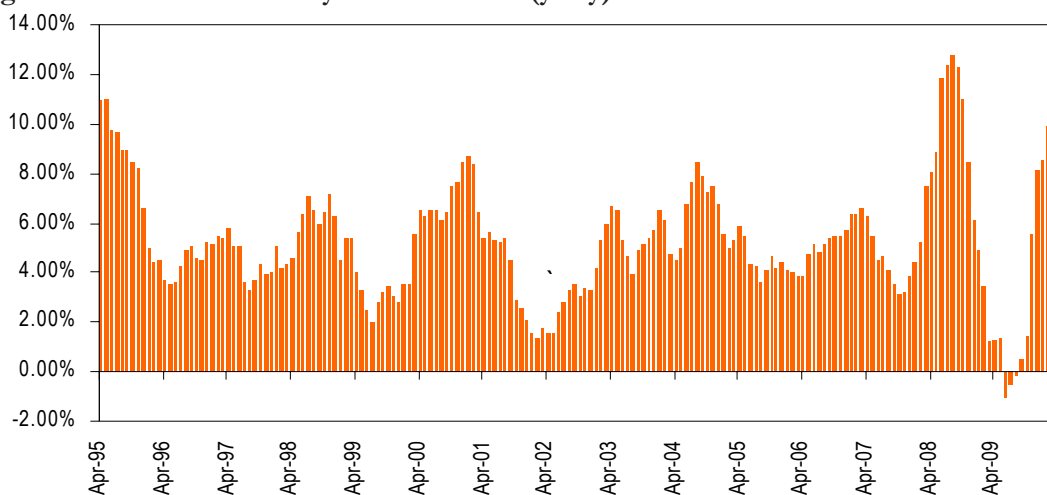
Rise in Demand & Inflation Expectations - A Concern

The movements in WPI inflation (y-o-y) have always been volatile due to seasonal factors and a statistical phenomenon. But, the degree of volatility went up considerably from 2008-09 and is persistent till date.

The WPI has three major sub-sectors i.e. Primary Articles, Fuel and Manufactured Products. The Primary Articles sub-index has always been quite volatile since it consists of mainly food articles and as one is aware that agriculture still is largely dependent on outcome of rainfall. The Fuel sub-index is not so volatile; since its major components like petrol, diesel and LPG prices remain administered. Therefore, the movements in this sub-index are abrupt and sharp, and lead to correlative movements in other two sub-indices. Movement in Manufactured Products sub-index, on the other hand, tends to be relatively stable but sticky.

Since fiscal 2008-09 until date, the degree of volatility in inflation has gone up largely due to relatively frequent and large changes to Fuel sub-index and its impact on other sub-indices. Continued instability in food prices and statistics has also played their part in increasing the degree of volatility.

Figure 3: Historical Monthly WPI Inflation (y-o-y)

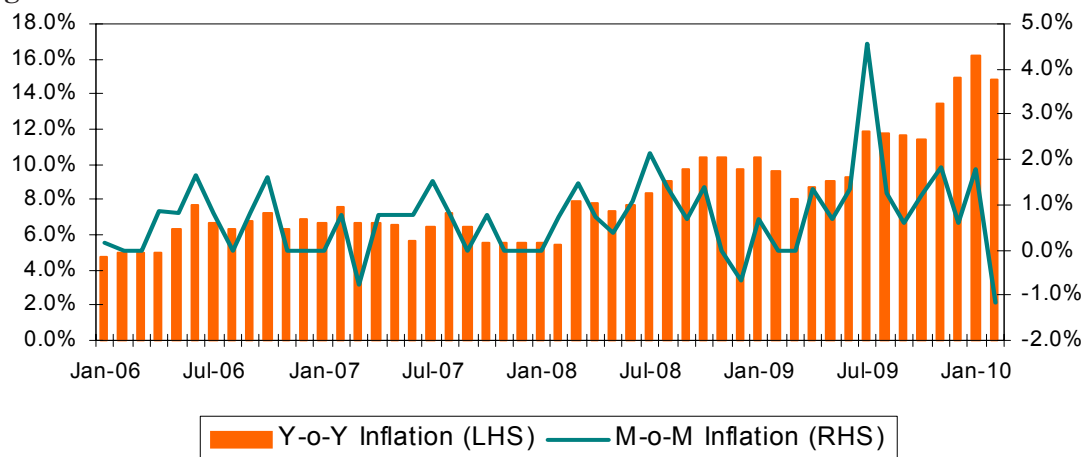


Source: IDBI Gilts Limited, Office of Economic Advisor - Ministry of Commerce

The fiscal year 2009-10 began with negative readings on annual inflation. This was despite an actual rise in index; thus exhibiting the impact of considerable negative base effect. But, since the beginning of third quarter the annual inflation has risen with an accelerating pace. This has been due to a considerable negative base effect. As a result, the annual inflation has only gone up, despite moderation observed in the m-o-m index rise. The average monthly growth in index over the first half was above 1.0% levels, which moderated to around 0.6% growth observed during the second half.

During the fiscal, the Manufactured Products index too has increased substantially; adding stickiness to an already high inflation number seen presently. It is this stickiness in price level that is a cause of concern, especially when there are evident signs of economy recovering and fueling demand side pressure on prices. Moreover, a sticky inflation also raises the level of inflation expectations in the economy.

Apart from WPI inflation, it is the persistently high reading on CPI inflation (y-o-y) that has also alarmed the authorities on the effects of the vicious price-wage spiral. Though, the number for February CPI has been subdued due to the fall in food prices.

Figure 4: CPI Inflation for Industrial Workers

Source: IDBI Gilts Limited, Labour Bureau - GOI

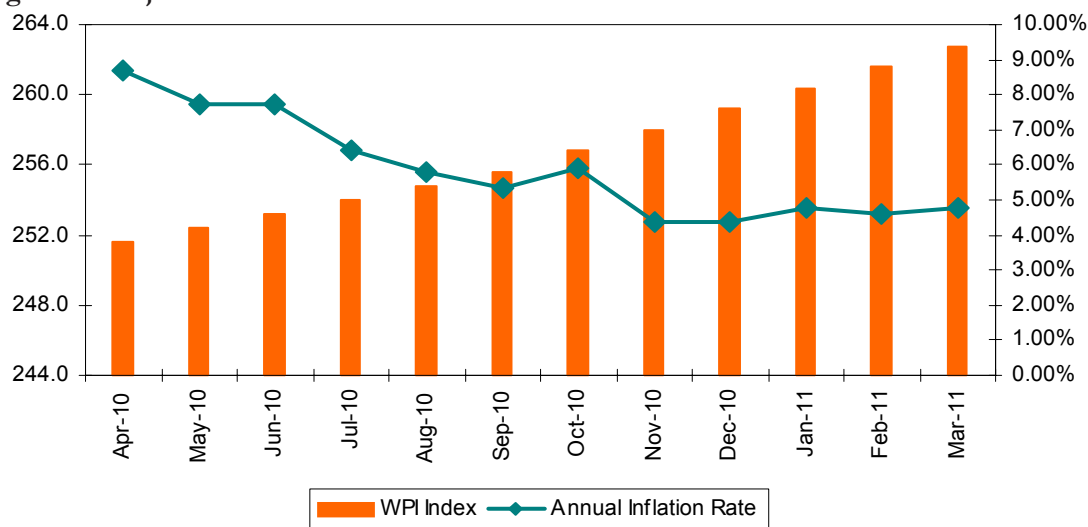
Outlook for Inflation

As mentioned earlier, the headline WPI inflation since third quarter has been affected by a huge negative base effect. This base effect is expected to wear off as we move into the fiscal year 2010-11. Therefore, it is quite possible that despite constant increases in index number, we may actually experience a fall in the annual inflation rate.

The broad outlook on inflation for 2010-11 could be divided into two scenarios --

Scenario One; wherein the global economy would continue with its subdued pace of recovery; clouded with uncertainty regarding the outlook. Under this scenario the markets would be engulfed in concerns on outlook for debt-laden European economies and their impact on other economies. Under this scenario advanced nations, primarily the United States, too would move along the moderate pace of recovery and amidst concerns over the unemployment levels in the economy. Under a dull scenario like this, the movements in prices of energy and commodities globally would largely be stable. This in turn would reduce the pressure on domestic price levels.

Scenario Two; wherein uncertainty regarding the outlook for some debt ridden European economies clears out and economic recovery picks up pace globally. Under this scenario the credit flow to productive areas, which is currently subdued in advanced nations, could improve and lead to overall improvement in consumption levels. This could further improve the growth outlook for advanced countries. Such a buoyant outlook may in turn lead to expectations driven rally in energy and commodities prices. This could then impact the domestic prices levels (for e.g. the rally in crude prices may call for rise in levels of administered fuel prices, and its spillover into manufactured products).

Figure 5: Projected WPI Headline Index & Annual Inflation Rate for 2010-11

Source: IDBI Gilts Limited

In all probability, the world economy may experience situation under scenario one at least till second quarter of calendar year 2010, post which the outlook may improve (as per scenario two) and lead to rising levels of energy and commodity prices.

On the basis of the above analysis the index could increase at a moderated pace, but pick up momentum from the end of first quarter of fiscal 2010. However, due to reversal of negative base effect, the annual WPI inflation rate may appear softer. Similarly the annual rate on CPI may also come down. Nonetheless, slight amount of uncertainty on inflation outlook remains, as regards the global developments and progress of rainfall in the country with its impact on domestic food prices

Could RBI Get More Aggressive???

The primary reason for a mid-policy hike in interest rates by RBI was the acceleration in inflation rate and the possibility of further upside pressure through rise in demand as well as inflation expectations. The above decision was supported by a sustained recovery in economy. However, if the economic data was seen in isolation, leaving aside the developments on price front, another round of rate hike at this juncture would have been questioned. Therefore we feel that a move to hike interest rates further by 25bps at the upcoming review would be primarily a step taken to control the build up of inflation expectations in an economy that is steadily recovering.

As discussed above, the developments in major economic indicators like IIP and GDP are in line with the historical trend and in no way suggest any kind of overheating. Therefore, higher than expected aggression by RBI in hiking the policy rates may give a jolt to the smooth recovery process seen till until date.

Moreover, one cannot ignore the huge borrowing programme slated for the fiscal year 2010-11. An aggressive move by RBI, to hike rates more than 25bps at this juncture, holds the possibility to distort the sovereign yield curve and raise the borrowing cost for the government.

A Hike in CRR - More for Unwinding Than Sterilizing

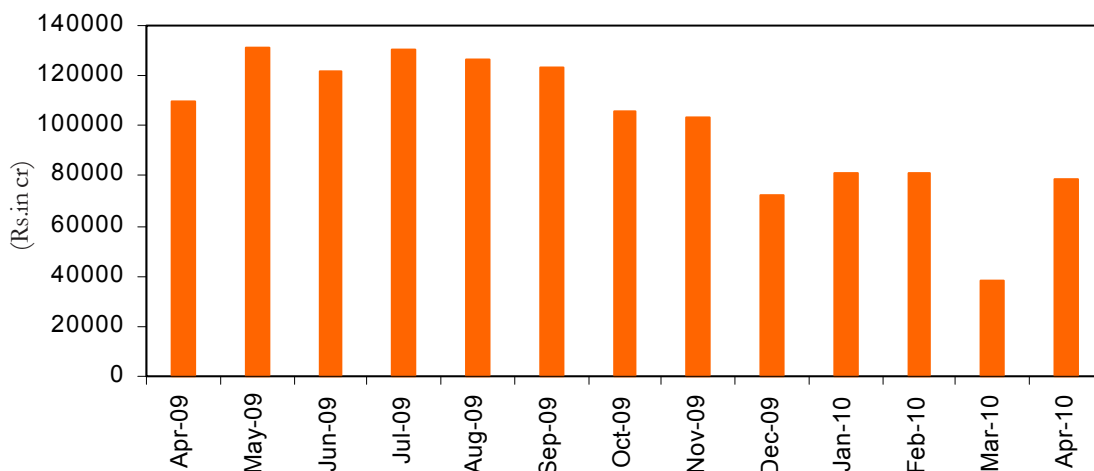
At the upcoming review of monetary policy we expect the RBI to hike the CRR by 25bps to 6.00%. The move would be a step further in unwinding the liquidity measures taken during times of recession and which have led to influx of liquidity. Moreover, persistently huge liquidity in the system holds the potential to inflate asset price in the economy. A 25bps CRR hike is expected to culminate into approximately an outflow of Rs 10,000 cr to Rs 12,000 cr from the system.

Therefore a move of 25bps on CRR purely made for above reasons would not hurt the markets and economy much. But a step taken (hike in CRR), and that too in a much aggressive manner, to curb influx of liquidity through foreign flows may not be seen in a positive light. It is commonly observed that a move on CRR undertaken to sterilize intervention driven liquidity acts as a tax on the banking system. This is especially true when the economy is on the path of recovery and credit offtake to productive & needy sectors has not been on expected lines.

Huge amount of foreign flows and the resultant need to intervene in forex markets no doubt increases systemic liquidity to a level that may create asset bubbles. But, hiking CRR is not the right way of sterilizing these flows. If presently the concern on liquidity through foreign flows exists, it needs to be dealt with by using the Market Stabilization Scheme. The Government has already made a provision of Rs 50,000 cr for issuance under MSS bonds. But during times of huge fiscal borrowing, issuance of MSS bonds may act as a dampener. Therefore, issuance of T-Bill under the MSS route may be seen as being more market friendly and also not lead to distortion of the sovereign yield curve.

Moreover, as the net LAF deployments have already come down considerably, a more aggressive move may not be well received. From the beginning of the fiscal year 2009-10, the average monthly net LAF deployments have come down considerably. The average deployments of roughly Rs 1,20,000 cr seen during the first half of fiscal 2009-10 has come down to around Rs 80,000 cr in second half of 2009-10. The net deployment over the past few days have in fact fallen to around Rs 50,000 cr.

Figure 6: Average Monthly Net LAF Deployments



Source: IDBI Gilts Limited, RBI

Besides, the RBI may be keen to keep the systemic liquidity adequate to ensure a non-disruptive subscription to the borrowing calendar. There could be arguments made for RBI to use the OMO route to ensure availability of adequate liquidity; but such operations have not been a complete success in the past. RBI too, in its Third Quarter Review, has stated that:

“... as the recovery gains momentum, it is important that there is co-ordination in the fiscal and monetary exits. The reversal of monetary accommodation cannot be effective unless there is also a roll back of government borrowing.”

“...even as the government borrowing had increased abruptly during 2008-09 and 2009-10, it could be managed through a host of measures that bolstered liquidity. Those liquidity infusion options will not be available to the same extent next year.”

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